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"For any industrial wave movement, it needs an initiating impulse. Such an impulse, when it comes into play, operates upon certain complex or industrial and monetary conditions. Given the impulse, these will determine the nature of the effect that it produces. The impulse is the dropping of the match; the consequences are determined by the nature of the material with which it comes into contact."

A. C. Pigou, Industrial Fluctuations
P.8, Macmillan & Co, London, 1927

HIGHLIGHTS

The economic picture in the United States is as mixed as never before — a buoyant stock market versus a real estate and banking crisis, soaring M1 versus steep declines in broad money and private credit growth.

These contradictions have one common cause: a monetary easing that is overstimulating the securities markets while only having a scant impact on the real economy.

Policy-makers and most economists still regard the 1980s as a healthy period of "disinflation." The truth is that America has experienced its worst credit and debt explosion in history.

Credit and debts expanded faster than ever before. But for the first time since the 1920s, the borrowed money flowed largely into the purchase of assets. That generated an asset-price bubble in stocks, bonds and real estate.

Our analysis makes tatters out of the Wall Street myth that the twin surge in M1 and the stock market is reliably signalling an economic recovery.

The fact that the rampant asset-price inflation of the 1980s was not reflected in the popular price indices has created confusion and, above all, a dangerous complacency.

It's in the nature of all speculative bubbles that they are unpredictable. Anything can burst them.

In reality, the long inflation in asset prices has caused unprecedented damage to the economic and financial structures. This damage has made the U.S. economy increasingly impervious to monetary stimulation.

The kick-start for a U.S. economic recovery must come from an appreciable increase in private-sector credit. That and nothing else is the acid-test proof that the Fed's easing is working.

Investors with a longer-term perspective should diversify into Europe where most countries have avoided an asset-inflation bubble and therefore are safe from the ravages of its deflationary aftermath.

THE SPINS OF WALL STREET AND THE U.S. ECONOMY

In something of a replay of last spring's forecasting fiasco, thundering voices are again chanting economic recovery when in fact there is none.

Most disastrously wrong, last year, were the international interest rate forecasts that inspired the bull run in the U.S. dollar. Instead of narrowing, as the consensus expected, the spread between D-mark and U.S. short-term Euro-market rates widened dramatically . . . to record levels. When the dollar started its explosive rise in mid-February 1991, the spread was already at a 20-year high of 250 basis-points (2.5 percentage points) in favour of the D-mark. Today, it's at an unprecedented 540 basis-points.

Yet, last year's forecasting disaster has done little or nothing to shake the general complacency over U.S. economic prospects. Even though recent signs clearly point to a new downturn in economic activity over the next few months, the markets prefer to take at face value the comforting words of Alan Greenspan, that the recovery is now in place. Decisively, the full point discount-rate cut in late December has created a bullish sentiment based on the view that the Fed is determined to revive the economy at all costs and that all that's needed to fix the problem is an even more aggressive easing.

A year ago, we dismissed all the recovery forecasts with one main counter-argument: that the collapse in private-sector credit growth severely negated any recovery. Lately, aggregate business and consumer borrowing has plunged from an annual level of $500-600 billion between 1985-89 to a rate of less than $200 billion. In terms of percentage growth, that's compares to rates of 13-14% and 2.5% recently. Private credit has tumbled from a year-over-year growth rate of over 13% to below 2.5% recently. That's a pace which is much less than the rate of compound interest. Given that consumer incomes and business cash flows are virtually stagnating, total purchasing power and spending cannot rise unless credit expands.

As such, to us, the credit figures will most likely provide the first clue of any recovery. That's why we focus on credit, credit and credit, the one aggregate which attracts the least amount of attention.

SPLIT MARKETS, SPLIT EFFECTS

In the meantime, financial developments are becoming increasingly contradictory. M1 is surging while broad money and private credit growth are at their lowest pace on record. Stock and bond markets have boomed while the real estate market — particularly commercial property — has collapsed and is starving of liquidity. What we see, in short, is overliquidity and hyper-inflation in the financial sphere; depression and savage deflation in commercial real estate and slow shrinkage in current output, incomes and GNP. It's truly an unprecedented mixture.

It has often been said that the financial markets have decoupled from the real economy. While this is true, the dichotomy of a prolonged financial mania and prolonged economic sluggishness is now going on since 1985, and intriguingly, is getting greater and greater. Shares make ever-new peaks in prices in defiance of an economy that is in its longest post-war recession. Similarly, the booming U.S. bond market defies the existence of an exploding budget deficit and record-low national savings.

While all this seems grossly illogical and contradictory, on closer look, it finds its basic cause in the U.S. economy's lack of responsiveness to monetary stimulation.

Actually, it's normal that a monetary easing first turns on the financial markets in times of economic slack. Usually, after some months, when business again begins to hum, the employment of money is shifted from the financial markets into the real economy. Stock and bond prices then go down while the economy recovers.

Ever since 1985-86, though, it hasn't worked out that way in the United States. Increasingly, aggressive monetary easing has lurched the financial markets into overdrive while the real economy has kept crawling.

THE ROLE OF INFLATION IN THE ASSET MANIA

The unrelenting optimism over the U.S. economy has one obvious cause: That is the widespread belief that "inflation has been licked" in the 1980s. That's what many regard as a condition for lower interest rates and an economic recovery.

There could hardly be a greater error. To be sure, measured by the price indices, inflation in the 1980s appeared to be far more moderate than in the 1970s. Measured by the rate of credit and debt expansion, though, the records were similarly horrible. The truth is that in terms of the resulting debt levels and misallocation of resources, the credit inflation of the 1980s was by far the more destructive one. That holds true for the United States, Japan, Britain, Canada and Australia.

In the United States, credit and debt expanded by 166% in the 1970s or from $1,339 billion to $3,560 billion. In the 1980s, these aggregates grew 175% or from $3,560 billion to a stupendous $9.805 billion. Nominal GNP, however, grew by 160% during the 1970s but only by a cumulative 108% in the 1980s. The crucial point of focus here is the vast growth gap between credit and GNP in the 1980s. Prior to that point, debt and GNP have grown in line with each other. In the 1980s, the relationship suddenly broke down; credit and money took off relative to GNP. (See the graph on the next page).

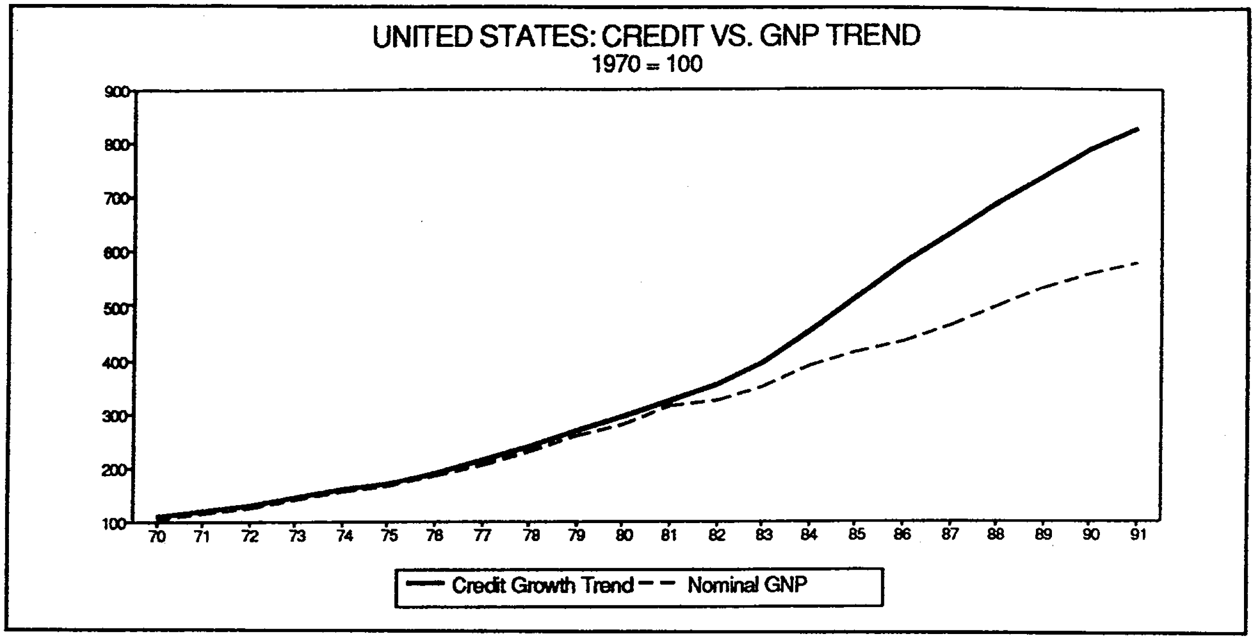
This brings us to a point which most policy-makers and economists completely ignore. It concerns the application of the money supply. Money always serves two fundamentally different markets — one for current output or GNP, the other for existing financial or real capital assets. Stock, bond and real estate transactions require and absorb money and credit just as do new investment and rising production. This former use of money, though, lies entirely outside of GNP.

What happened in the 1980s was that the inflationary money and credit creation, spilling out far in excess of the needs for the production of goods and services, massively flooded into financial leveraging and speculation. That caused a runaway asset-price inflation.

During the 1970s, by contrast, the American credit inflation went fully into goods and services, inflating prices all-round and causing a rush into tangible assets which had the highest price inflation. The two most spectacular hallmarks of that era was the soaring price of gold and, in contrast, depressed stock and bond prices.

THE WORST ASSET BUBBLE IN HISTORY

It's important to see that the 1980s type of inflation was radically different in its pattern. The truth is



that this new inflation was far more intense than that in the 1970s. But what blinded most people to this fact was that the inflation occurred in an area which traditionally has not been associated with inflation — the securities markets. The most spectacular feature of this inflation is the endless stock market boom.

This stock market boom, in turn, breeds the widespread perception that the U.S. economy is in basically good shape and is primed for the next upturn even despite the huge luggage of past debt. Those taken in by this prevailing, superficial analysis see such elements as the unusual length of the past economic expansion, the persistent stock market boom, and the relatively subdued price inflation as evidence of economic health.

THE PARTICULAR EVILS OF ASSET-PRICE INFLATION

As a result, it became the worldwide consensus view that economic developments in the United States during the 1980s were far more healthy than in the 1970s. The main gauges for this rosy assessment are the lower rates of inflation and the prolonged stock market boom.

Actually, internal consumer price inflation was at the same time largely suppressed by the exploding U.S. trade deficit. In other words, domestic price inflation was diverted abroad.

The most dangerous part of the 1980s inflation was the long rampant asset-price inflation. Few policy-makers and economists ever understood this type of inflation though it had its last historic precedent in the U.S. during the 1920s. Only, this time, the excesses are even worse.

Just as in the 1920s, the booming stock market was considered a symbol of economic health given the low inflation in the prices for goods and services. The shocking reality is that this asset-price inflation has inflicted unprecedented damage to all the concerned economies and their financial systems.

Definitely, the damage incurred is far greater and for more dangerous than that caused by the product-price inflation of the 1970s.

. . . SKYROCKETING DEBT LEVELS

In the first place, the asset-price inflation of the 1980s has caused unprecedented overindebtedness. Remember that debt grew a cumulative 175% while GNP and income only grew 108%. Debt, which had remained around a level of 130% of GNP for a long time, shot up to an unprecedented 197% of GNP.

The product-price inflation of the 1970s, in dire contrast to the asset inflation of the 1980s, caused no debt or banking problems. When Paul Volcker, in 1979, began applying his savage monetary squeeze eventually driving up interest rates as high as 20%, he didn't worry about financial fragility. Debts had been inflated away relative to incomes and profits. The losers of that inflation were those with fixed incomes and the owners of financial assets. What's more, the U.S. economy did lose much of its dynamism; productivity growth collapsed.

Importantly, the decisive thing to realize is that asset-price inflation serves up an explosive leaven: soaring collateral values. As the excess money pours into financial and real estate markets, artificially buoying prices, liquidity standards are waived. Ever-increasing collateral values justify and support ever-increasing loans in ever-increasing neglect of underlying incomes and cash flow. That's what makes asset inflation so alluring . . . and such a powder-keg.

History and logic say that all runaway asset-price inflations essentially end in a full-blown financial crisis. Whenever borrowing and lending slows — inevitably it happens one day — the inflated collateral values recede and plunge while the debts remain fixed in nominal terms. As the decline unfolds, loan and capital losses escalate both for borrowers and lenders, severely impairing the whole credit machine.

These observations point to the real danger today — a critical mixture of overindebtedness and a spreading scramble for liquidity, which, in turn, causes a vicious, self-feeding downward spiral of spending retrenchment, falling asset prices and deepening recession. That's the key contrast to the product-price inflation of the 1970s which instead depreciated debt burdens by inflating prices, incomes and profits.

. . . A MASSIVE MISALLOCATION OF RESOURCES

The ballooning of debt relative to income, cash flow and collateral values — overindebtedness being the result — is only one part of the dire aftermath of a rampant asset-price inflation. The other part comprises the maladjustments in the real economy which result from the massive diversion of financial and real resources into unproductive use.

In the last letter (page 8) we listed five maladjustments which have occurred in the U.S. economy's output, demand, and price structure: record-low savings, record-low business profits, low productive investment, overconsumption, and record high malinvestment particularly in commercial real estate. All of these boil down to a number of structural effects which essentially undermine the U.S. economy's

long-term growth potential.

Before we leave the topic of asset-price inflation and its consequences, a few conclusive remarks are in order. We said that the last time such an inflation occurred in the United States was in the 1920s. Then, quite a few American economists recognized that a persistent credit expansion in excess of GNP growth was a danger signal because it essentially fuelled financial speculation. Today, sixty year later, the experts seem to be totally unaware of this principle. Grotesquely, many American economists virtually celebrate this asset inflation in financial securities as a new "era of disinflation." Directly to the contrary, it's runaway asset inflation that leads to a financial bust.

THE MONEY RIDDLE

The confused discussion about the chameleon-like manifestations of inflation has its counterpart in a similarly confused discussion about the behaviour of money supply. Though hard to believe, it seems that few money experts really understand the processes by which money is created and destroyed. In that respect, we even wonder about the Federal Reserve.

Here, we come to another key question: How effective is the Fed's easing? Looking at the different monetary aggregates, the evidence is as conflicting as never before. M1 is speeding ahead at double-digit rates while M3 and M4 growth, the broadest aggregates, barely hover above zero. Taking inflation into account, they are actually contracting.

Understandably, the buoyant M1 performance has a lot of fans on Wall Street who point to it and the exploding stock market as sure-fire signals of a strong economic recovery. Yes, money talks, but only when one understands what the letters mean and how the money aggregates work.

COMFORTING FALSE EXPLANATIONS

There are a number of popular arguments that are used to prove-up the significance of the M1 trend. Some economists preach that deregulated financial markets have disrupted the formerly close links between money growth and nominal GNP growth. Given that new reality, they claim, if anything, only M1 matters.

Others argue that the broad money aggregates (M2, M3 and M4) are not as good indicators of economic activity as M1 because these aggregates include so much savings and money that's not being spent and put into motion.

The most popular explanation for the persistent broad money weakness is the concept of a portfolio shift. It argues that investors are shifting out of low-yielding deposits and money market funds en masse (both of which are components of M2 or M3) into assets offering higher yields or prospects of capital gains such as stocks, bonds and stock or bond mutual funds (which are outside of the money supply.)

To be sure, such portfolio shifts have taken place at a vast scale. The only rub is that the comforting assumption about their impact on the monetary aggregates is false. This portfolio shift explains the surging M1 but not the unusual weakness of the broader money aggregates.

Please think the process through with us for a moment. What really happens when all these time deposits or money market funds shift into longer-dated securities and/or mutual fund shares? First, in these transactions, investors have to convert their time deposits into demand deposits. Next, these demand deposits are transferred to the seller or issuer of the securities that have been purchased.

The most obvious effect is that M1 rises. But the great error is the assumption that M2, M3 and M4 must fall correspondingly. That cannot be the case because M1 is a constituent part of them. What changes is their composition but not their total sums. The government or the mutual fund, for example, (the recipients of the investment shift) will in turn quickly spend these demand deposits — the government on some expenditures, the fund on some new securities purchases. Doing so, they both pass along the demand deposits again to others . . . and so on. The money continues to circulates as M1. Again, we repeat, M2, M3 and M4 are not reduced.

Take note of the following numbers: In 1991, M1 rose by $71 billion, M2 by $98 billion, M3 by $61 billion and M4 rose only $49 billion. In other words, the whole increase in broad money results from the M1 surge which is counted as part of all the other M's.

It should be clear what the key and truly decisive question is: What kind of transactions are presently driving M1? Is its surge related to the real economy (GNP) or to the financial sector? The truth couldn't be more evident. The surge in M1 is clearly related to the burst in financial activity which is driven by the speculative bubble in both the bond and stock markets. The unusual new feature, though, is that the money flooding into financial speculation largely comes from a sinking real economy.

THE EFFECTIVENESS OF MONETARY POLICY

The prolonged and sharp divergence between the growth rates of narrow and broad money over the last two years is unprecedented. Does that trend tell us something about the effectiveness of the present monetary policy? Yes. In fact, we think it gives us a conclusive answer.

Actually, the present situation finds a certain parallel in 1985-86. That also was a time of a drastic monetary easing. The following table provides the comparative annual figures for both periods. Recently, over the last three months, M1 rose at an annual rate of 11.4%, M2 at 2.9% and M3 at 1.7%.

UNITED STATES: CREDIT AND MONEY GROWTH
(Annual, % Growth)

	M1	M2	M3	M4	Debt	Private Debt	Real GNP
1985	12.4	8.2	7.2	8.7	13.6	13.6	3.4
1986	16.8	9.4	9.1	8.1	12.7	11.9	2.8
1990	4.0	3.3	1.4	1.6	6.6	5.2	1.0
1991	8.6	2.9	1.5	0.8	5.0	2.9	-0.7

Now compare the monetary pattern of 1985-86 with that of 1990-91. Both periods had exceptionally strong M1 growth. In 1985-86, M1 soared by 12.3% and in 1986 by as much as 16.8%. Presently, M1 is surging at a rate of around 11.%. The great contrast is in broad money growth. In 1985-86, they, too, expanded at high rates while, now, they are sluggish as never before.

Trying to assess the effectiveness of monetary easing, we ought to distinguish between monetary effects (the impact on money and credit growth) and the effects on the real economy. A monetary easing does

not directly affect demand; it works through its impact on the financial system. Money and credit expansion come first while the effects on the real economy arrive somewhat later.

As can be seen, there are some great anomalies between the two periods. In 1985-86, the Fed's easing proved highly effective in overstimulating the monetary aggregates and fanning up the speculative embers but proved pretty ineffective in strengthening the real economy. Instead, asset inflation completely spun out of control. Remarkably, real estate, a sector which is essentially sheltered from foreign competition, was the one and only part of the economy that took off. When the economy's upturn finally arrived in late 1987, it was export-led, triggered by booming foreign demand and the prior dollar collapse.

Today, just as in 1985-86, it's the real economy's inertia that has provoked the Fed to become increasingly more aggressive in its monetary easing. So far, Mr. Greenspan hasn't even been able to scare up the monetary aggregates let alone the real economy. Money supply is showing its worst decline since the 1930s. Yet, virtually by default, financial speculation blossoms as never before with the result that the baffling dichotomy between the financial markets and the ailing economy grows ever wider. Economically it's crazy, although mechanically there is some logic.

WHAT LOW CREDIT AND MONEY GROWTH PREDICT

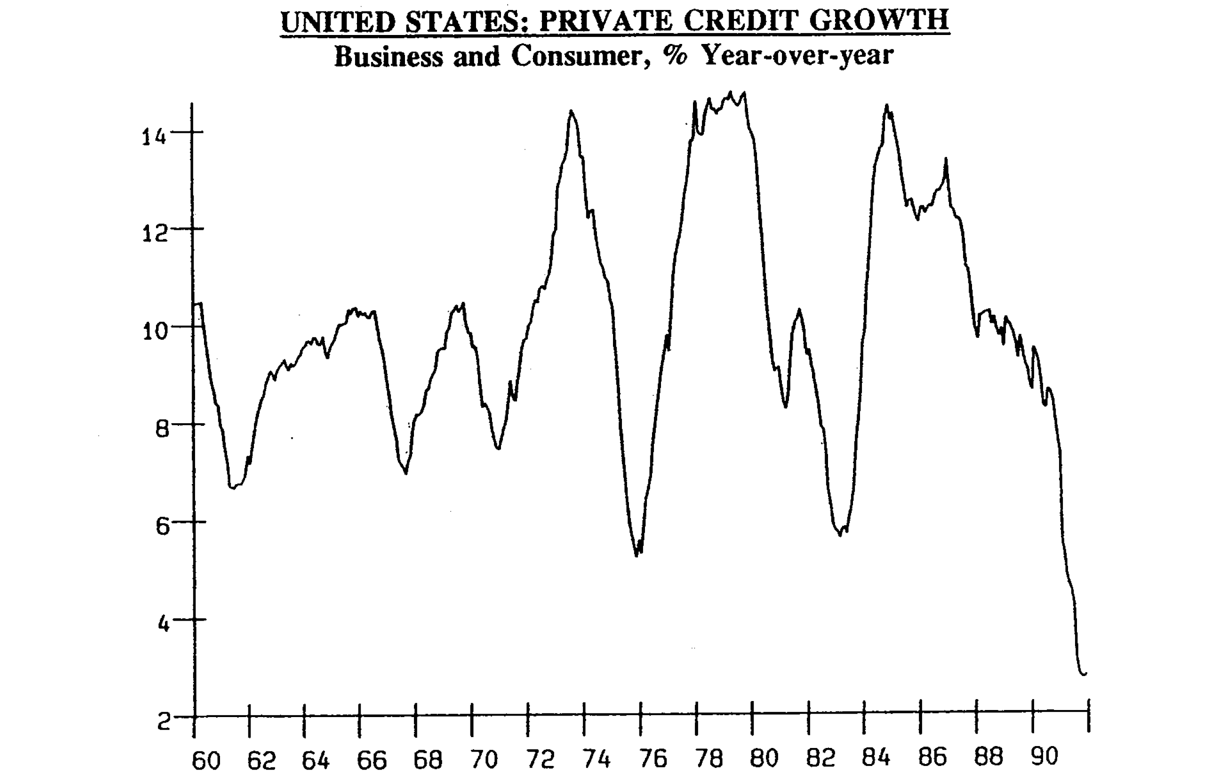
For good reason — apart from dreaming up the deflecting arguments we reviewed earlier — Wall Street is generally keeping quite silent about low money and credit growth. These details don't fit their "boom time" stories. We're asked to close our eyes and to rely on the bullish message of M1 and the stock market. Many are obliging.

Mr. Greenspan has now been easing since mid-1989, slashing short-term interest rates to lows not seen in decades. Just what has been achieved in these last 31 months? Stock and bond markets may have entered hyperspace but the essential expansion in money and credit has not been forthcoming. Despite everything, private credit continues to plunge as never before, correspondingly contracting the available purchasing power and signalling worsening monetary conditions. (See the graph on the following page). The point to see is that for the first time since the 1930s, the financial system refuses to respond to a drastic monetary easing by increasing its outstanding loans. So far, it's proving to be the ill-reputed "pushing on a string".

Essentially, the real estate market is bearing the brunt of the unfolding credit and liquidity crunch. As real estate prices fall, so spreads the well-documented and vast destruction of capital caused by defaulting borrowers and their lenders whose safety margins on collateral are consumed.

All these considerations leave us with the key question which we touched upon earlier. It concerns the relationship between the buoyant financial markets — stocks and bonds, particularly — and the real economy's prolonged sluggishness. At issue, really, is the Wall Street myth that the stock market always proves to be the most reliable indicator of an economic recovery.

Since this disparity between the financial and real sector has already lasted for such a long time, more and more we have come to the conclusion that the causality is exactly converse. It's precisely because the real economy persistently fails to respond more strongly to monetary stimulation, that money hypes



Source: International Investment and Strategy

the financial sphere by default. Only speculators, though, are taking the bait of easy money, not so much businesses and consumers.

Instead of signalling recovery, the protracted bullishness of the financial markets in reality forecasts protracted economic weakness. That's certainly plausible enough. Wall Street's fairy tales have a lot less logic.

The balance sheets of the banks tell the story in a nutshell. Last year, U.S. commercial banks expanded their holdings of government bonds by $106 billion or 24% while they contracted their loans to the private sector by $16 billion. Add to this a further $30 billion in government bonds which were purchased by the Fed and you have a massive money creation taking place through the agency of government debt. Yet, the extreme weakness of broad money persists and becomes very ominous.

The banks of course, are not alone in playing the steep yield curve in America. Investors and traders all-over the world are doing the same, borrowing cheaply at a rate of little more than 4% to buy longer-dated paper yielding up to 7.50%. But this time, in contrast to the 1980s, the funds for this speculation aren't solely coming from U.S. domestic banks. The fuel is being supplied by U.S. non-banks (pension funds, corporations) via the call-money market and from the Euro-market. Therefore, this speculation mostly doesn't result in the creation of new deposits. But, it does tend to boost M1.

All this conjures up the picture of a car on an icy roadway leading up an incline. The driver is trying to accelerate by stepping on the accelerator pedal. The wheels may spin faster and faster but the vehicle does not move forward. The car has lost traction . . . and may even begin to slip backwards.

Conclusively, we think, our analysis makes tatters out of the Wall Street "spin" that the twin surge in M1 and the stock market is reliably signalling an economic recovery. Even if this relationship has worked in the past, the evidence is that it has broken down like so many other relationships because the real economy and financial system are too severely maladjusted.

MORE MANIA?

How long can the asset bubble go on? It's all a question of liquidity and psychology. M3 and M4, the widest measures of liquidity, unmistakably say that overall liquidity continues to shrink, affecting the real economy and above all the real estate market even though financial markets may still be frolicking.

Deflation, just like inflation, may impact individual sectors very differently. That may be so for a number of reasons. Partly, as explained, the financial markets attract idle money from the sinking real economy by default. Secondly, financial speculation today largely takes place through derivative financial instruments which require very little cash but can easily lever up the spot markets. Thirdly, large pools of liquidity can remain immune from deflationary pressures for a time while they remain bottled up in non-bank sectors such as pensions funds. In addition, we guess that international liquidity — mostly through the Euro-market — is heavily involved thereby also buoying the dollar.

The bottom line of all this boils down to two conclusions that are at radical loggerheads with present market perceptions: (1) the financial markets can easily decouple from the domestic money supply; and (2) the stock market has lost any predictive power for the real economy. It seems that a financial earthquake is necessary to starve financial speculation of its liquidity. Ironically, slow economic growth may be the greatest stimulant of speculation.

However, besides liquidity, bull markets need psychology to hype them. Presently, it's the consensus expectation that inflation is licked in the United States and the other English-speaking countries and that the best kind of recovery is around the corner . . . a non-inflationary one that brings expanding price/earnings multiples with it. That couldn't be more wrong.

GERMANY AND EUROPE — THE STRIKING CONTRAST

While the consensus revels in its bullish forecast for North America, it continues to downcast European prospects. Expectations of rising interest rates in the U.S. and talk of an onset of recession in Germany (and further downturns in Continental Europe) with attendant declining interest rates there, contribute to the consensus case for a rising dollar and a falling D-mark.

Yes, German GNP will be flat to down in the fourth quarter following slight declines in the second and third quarter. But to categorize Germany as being in a recession is shortsighted. Such a pronouncement does not take into account that real domestic demand in Germany has risen by 11% over the last three years while only growing 1.5% in the U.S, the latter of which all took place in 1989. It also overlooks the fact that capacity utilization in Germany is still around the boom-time level of 87% while U.S.

utilization is at a recessionary 79%.

The key difference between the U.S. and Germany is this: The Bundesbank is voluntarily fighting an overheating economy that resulted from German unification while the U.S. economy is involuntarily mired and still slumping in its third year of recession despite the Fed's increasingly aggressive monetary policy.

The German economy may well surprise the consensus this year by its unexpected strength, though, there'll likely will be a shift of growth from the west to the east. Just about everybody seems to overlook two important developments: first, a 7.5% income tax cut is due on July 1, 1992 when last year's temporary tax hike expires; and secondly, a sharp acceleration in money and credit growth.

It's a great error to believe that the Bundesbank's recent interest-rate hike was solely or mainly induced by high wage claims. The key point of focus for the Bundesbank always is money and credit. Money growth is currently punching out of its target band of 3.5-5.5%. Compared with a year ago, M3 is still just within its target range. But that year-over-year comparison masks an upturn in M3 growth of 8% since mid-1991 and is associated with a credit growth of 11%.

For the time being it's difficult to definitively interpret these trends, but what is definite is that it precludes any possibility of a monetary easing in the foreseeable future even if wage settlements prove more modest than feared.

A point to ponder is this: U.S. government bond yields have risen 60 basis points since the Fed discount-rate cut of December 20, 1991, whereas German yields have fallen 40 basis points since the Bundesbank raised its discount rate on December 19, 1991. Rather than confirming the U.S. recovery, we would rather say that the sharp rise in U.S. long-term rates adds to the many recovery obstacles.

CONCLUSIONS

The key conclusion from our analysis is that the financial sector has virtually decoupled from the real economy in the United States. Relationships that have worked in the past have broken down because the real economy and financial system are too severely maladjusted.

Another important point to see is the U.S. economy has yet to see a move towards a better balance. Every single important fundamental is progressively deteriorating — budget deficits, savings, debt-income and debt-asset ratios, the continuing credit crunch, business profits, consumer incomes, international growth and interest rate differentials. Control over fiscal and monetary policy has been lost. Yet, the markets anticipate recovery.

Not every country has travelled down the road of rampant asset inflation. The United States, Britain, Japan, Canada and Australia are the notorious players in that regard. Most of Europe has avoided this destructive type of inflation. The rigours of the European Monetary System (EMS) have kept monetary policy and monetary aggregates well under control. Menacing imbalances are absent. Of course, these countries are not immune to cyclical recessions caused by tight money. What they don't face is the economic and financial fallout of a severe asset-price and debt inflation that is currently acting as long-term depressant on the U.S. and other economies.

The U.S. recession, by contrast, reflects a deeper, secular change. The existing economic and financial maladjustments virtually guarantee a long period of slow economic growth, if not stagnation or worse. That means that interest rates must remain low at internationally unattractive levels. In any case, after such a long, dogged recession, the Fed will think hard before nudging interest rates up again, particularly so if the recovery proves as feeble as is now generally expected.

In short, U.S. economic, financial and monetary conditions are as negative as never before since the 1930s. The real economy is under no delusions in that regard. The key question is when will reality impact the speculative bubbles in the stock, bond and currency markets.

The U.S. stock market is clearly within a blow-off phase, ignited by the Fed's frantic easing and optimistic hopes. With the real economy remaining totally unresponsive, stock and bond speculation is simply the "only game in town." Still, it's a bet on an imminent economic recovery. In the meantime, though, debt and asset deflation continue unabated.

What's most alarming is the inevitability of the long-term trend. Investor with a long-sighted perspective should diversify into European hard-currency bonds. For the short-term — 1992 to 1993 — they offer higher yields plus capital gains. More importantly, such investment serve to protect against the dollar's inevitable further depreciation over the longer run.

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